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# Conference Proceedings: American Property in a Hazardous Global Economy

Levy Institute

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The Jerome Levy Economics Institute of Bard College

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*of Bard College*

# American Prosperity in a Hazardous Global Economy

## Conference Proceedings

**Including speeches by**

**The Honorable Lawrence H. Summers,** Deputy Secretary, U.S. Department of the Treasury

**The Honorable Robert Bennett,** U.S. Senate

**The Honorable Daniel Patrick Moynihan,** U.S. Senate

**David A. Levy,** Vice Chairman and Director of Forecasting, The Jerome Levy Economics Institute

*October 26, 1995*

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*Washington, D.C.*

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The Jerome Levy Economics Institute of Bard College, founded in 1986, is a nonprofit, nonpartisan, independently funded research organization devoted to public service. Through scholarship and economic forecasting it generates viable, effective public policy responses to important economic problems that profoundly affect the quality of life in the United States and abroad.

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# Foreword

*This is a conference on the current state of the U.S. economy and its prospects for prosperity in a changing economic world. At present the American economy is up. Some people feel euphoric, but we do not know how long the euphoria will last. We are being told that we have achieved a soft landing, the strong economy will continue, and more jobs will be created, but we also hear that layoffs continue because of corporate restructuring and "right-sizing" and new research findings warn us that disparity of income in our population is increasing.*

*Any analysis of or forecasts about our economy must take into account that our economy is global. Concepts such as competition, competitiveness, productivity, and business cycles must be viewed in terms of other economies. We know that we are global citizens. Until recently, the only American company manufacturing television sets did so in Mexico. At the same time, a significant number of American electronics engineers and designers involved in research and development relating to the new generation of televisions in the United States did not work for American manufacturers. Their employers were Dutch, French, or Japanese. The McDonnell Douglas airplane is not American, nor is the Airbus plane European.*

*We are living in an increasingly integrated international economy, where capital, technology, and even labor are mobile. Several questions pertinent to our prosperity arise from this fact: How do we identify "them" and "us" and what difference, if any, does that distinction make? Do our living standards depend on BMW in South Carolina, General Motors in Mexico, IBM programmers in India, and Toyota Motors in Tokyo?*

*In the early 1960s we were told that a rising tide lifts all boats. We know that in the 1990s this is not true. Perhaps the question most relevant to this is, Are we all in the same boat? Is the global economy hazardous to U.S. prosperity? Discussion of these questions is the mission of this conference.*

*Dimitri B. Papadimitriou*
*Executive Director*

# Speaker

## The Honorable Lawrence H. Summers

Deputy Secretary, U.S. Department of the Treasury

I would like to talk about the idea of progress in the American economy. If you think about American history for the last two centuries, our economic history has been defined by progress. That is why we are the richest country in the world by a wide margin. For two centuries, with amazingly few interruptions, America has grown more prosperous. The American GNP machine has had more output each year for every generation, and the fruits of that GNP machine, that extra output, have been distributed to make better lives for all our people. Thus, the vast majority of American parents have been able to look forward to a future where their children will live better than they were able to live.

What is important today is that the American GNP machine is working better than it has in a very long time, but that GNP machine is no longer providing the kind of benefits it once did to assure that prosperity is shared by all our people.

What is the progress report on the American GNP machine? We are now a $7 trillion economy. In the last three years we have created 7.5 million jobs. We have grown output by half a trillion dollars. We have expanded more rapidly than in many years the economy's capacity to produce. The stock market has created well over a trillion dollars in extra wealth.

Why are we making such rapid progress in growing the economy? We are making it most of all because this country has the most remarkably dynamic private sector in the world. If one views the changes that have occurred at the GEs, GMs, and IBMs and compares them to the changes that have taken place, or have not taken place, in major European or major Japanese companies, then one understands why we have made such progress. It says a lot about the future of American business. According to one study, 60 percent of American managers use personal computers in their work and the corresponding figure in Japan is less than 10 percent. American financial markets have forced a discipline that has led to tremendous improvements in productivity.

Although the restructuring efforts of major U.S. companies have proven successful at raising productivity and increasing export potential, probably even more profound as a source of competitive advantage is what the entrepreneurial sector of this economy has been able to accomplish. In many ways 1995 is a special year. One way is that it is likely to be the year in which the world's software market exceeds the world's hardware market, and America is distinctively good at software—so good that Microsoft is now one of the 10 most valuable companies in the United States in terms of market capitalization.

Whether the future is in technological innovation, such as software or biotechnology, or in the burgeoning service sector—the Federal Expresses, the Disneylands, the Walmarts, and the McDonaldses—American models are dominant everywhere. For this reason comparisons consistently show that American living standards on average are far greater than those in the major countries with which we compete. It now appears very likely that for the entire decade of the 1990s, after four decades in which the dominant story was convergence (other countries catching up with the United States) U.S. GNP growth will be more rapid than GNP growth in Japan and in Europe.

A crucial part of that success has been the American economy's success in exporting. We have extraordinarily competitive products produced by extraordinarily competitive companies. Our export success also has been based, in recent years, on a government that has worked very hard to promote exports by removing controls, by getting behind its exporters in their negotiations with foreign governments in the way that other countries do, and by working to bring down trade barriers through the GATT, NAFTA, and other agreements. This has led to a renaissance in

American exports, with increases of more than 20 percent in the last year.

I think it is fair to say that, based on the success in promoting exports and on the success of our companies, we are in many ways in a better position in an aggregate economic sense than we have been at any time in my professional lifetime. Indeed, today the United States is enjoying the first investment-led, low-inflation recovery since the 1960s. We have had low-inflation recoveries in the past; we had one in the mid 1980s. We have had investment-led recoveries in the past; Jimmy Carter had one. But we have not had that combination for many years.

I think a large part of the reason why inflation is so low and why the investment share of GDP, particularly in equipment investment, is higher than it has been since the Second World War is the progress we have made and the progress the markets see we will make in bringing down the budget deficit.

Before we talk about any further progress, it is worth remembering that the budget deficit has come down three years in a row for the first time since Harry Truman was president. The United States, after all these years, has the lowest budget deficit relative to its GDP of the G-7 countries, and the share of GNP taken by our budget deficit is half of what it was just three years ago. Building on that progress, everybody in Washington has agreed that we need to balance the budget and that we need to do it by reducing expenditures in the years ahead. That provides a strong macroeconomic foundation for growing capacity and low inflationary pressure, which I believe means that this recovery has a very long time to run.

But you know, as President Clinton's advisers said so often during the 1992 campaign, "It's the economy, stupid." The aggregate economy, the GNP machine, is working remarkably well, but there is more to the economy than aggregate GNP, namely, promoting prosperity for all of our people and protecting America's role as a leader in the world. I have to say that I am gravely concerned about this. George Bush in his inaugural address said, famously, that we have more will than wallet. He was wrong. We are a $7 trillion economy that has created an extra half a trillion dollars in output in the last three years. We have the material resources to keep making progress and providing better lives for all the people in this country.

And yet, think about the budget that we are now debating. Think about what the budget proposals now going through the Congress would mean for the idea of progress in America, measured not relative to some hypothetical baseline of an absolute increase, but measured relative to what happened absolutely. A child conceived today would have a mother who would be less likely to have access to prenatal care. The child would be less likely to have access to a basic preschool education through the Head Start program. God forbid that the child were abused, the capacity of the government to provide foster care would be cut back. If that child went on to school, the capacity of the federal government to provide support for the child's school would be cut back. If that child were to get sick and were unlucky enough to be one of the one in five American children who will live in poverty, the ability of the American people, the willingness of the American government, to provide support for medical care for that child would be reduced. If that child were to become disabled, he or she could well be among the 775,000 fewer such children who will have access to the Supplemental Security Income program. If that child chose to go to college, he or she would face a reduction in the availability of student loan programs. When that child went to look for a job, there would be less federal assistance through the employment service to match a job seeker with employment. If that child had children of his or her own, federal support for those children would be reduced. As that child went through the life cycle, free health care for the aging would be less available.

This is a country that has always made progress by taking the fruits of its GNP machine and expanding what it can do to assure that all the members of our American community share in a minimally adequate way. We are not now discussing broad and large new entitlements that push the envelope further. We are discussing whether we are going to turn backward. I think that, given the idea of progress in America, that would be a very grave mistake. We are discussing progress versus regress in a different way and in a way that is more difficult to make tangible, but in a way that I think is no less important, namely, what the United States is prepared to do to lead internationally.

For the last 50 years the United States has taken a leadership role internationally. An important part of the progress that we have made as a nation is the difference in the approaches to international life we took after the First

World War and after the Second World War. After the First World War we turned inward. We made no effort to rehabilitate the vanquished nations. We made no effort to open our markets. We made no effort to support the development of international institutions that would replace bang-bang with talk-talk. What followed were 20 of the darkest years in our history—the Great Depression, stagnation, and, ultimately, the Second World War.

After the Second World War the United States behaved very differently. We recognized that if the world was to be led, the United States had to lead. We expanded our capacity to produce. We used the fruits of that postwar economic boom to support a worldwide movement toward economic integration and to support the development of international institutions—the United Nations, the IMF, the World Bank—which have done a great deal to foster prosperity around the world and which have had as an important part of their mission spreading market capitalism around the world.

Today that commitment to leadership is being challenged. If the United States had to spend the same share of its GNP on national defense as we did just 10 years ago, we would be spending an extra $175 billion annually. Can anybody doubt that preventive diplomacy works through these institutions by making it less likely that there will be future Somalias, future Rwandas, or future Bosnias and by supporting the spread of democratic capitalism? Can anybody doubt that continuing to spend 1 percent of what we have saved is a worthwhile investment in continued leadership? I cannot.

I think those who are committed to America as a progressive force in the world should be able to understand why we should take 1 percent of what we have saved and put it into defending the security interests of tomorrow by supporting U.S. commitments to the major international institutions. Make no mistake. For all the talk about emerging markets and about economic integration, their history has not been a steady march of progress from darkness into light. All the themes in today's debate—increased economic integration, capitalism, rising markets—were there in the very early part of this century before we saw terrible conflicts. There was no leader then; that had a lot to do with why those conflicts took place.

I am here to say that we have an unrivaled opportunity because what determines the potential and the capacity of our economy is what that GNP machine can do. And it is in better order than it has been in a very long time. It is humming along very efficiently. Ultimately, that is not the test by which history will judge us. History will judge us by what we are able to do with what that machine can produce, whether we are able to translate its progress into progress for all American people and for people around the world. There is a choice to be made: Are we going to go back to the rugged individualism and isolationism of the nineteenth century or are we going to carry forward the American idea of progress into the twenty-first century?

# Speaker

## The Honorable Robert Bennett
U.S. Senate (R–Utah)

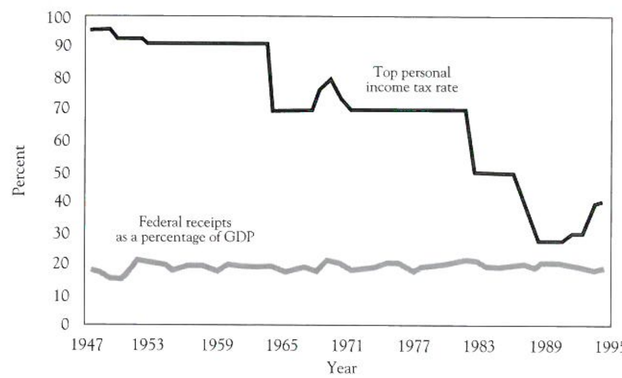
I came to Congress with a business background and with some political experience. My greatest frustration has been not being outvoted, as we were in the 103d Congress, but simply being misunderstood. Coming from the business world, there are certain things you know; when you try to explain this knowledge to people in the political world, they say, "No, that doesn't fit the ideology. We are not going to pay any attention to your facts."

I was frustrated in the tax debate of the 103d Congress by the tremendous misunderstanding of what really happens with respect to taxes. On the floor of the Senate I asked, "Is there anybody here who knows what a K-1 is?" No one in the Senate knew what a K-1 was. Recently the president said that people earning over $250,000 are going to pay the most taxes. Seventy-seven percent of the tax returns represented by this group of people contain K-1 income, but nobody knew what a K-1 was and how K-1 income was affected.

I think Exhibit 1 should become the standard chart for people to refer to when they discuss taxes and tax policy. The top line on the chart is the percentage of income taken by the top marginal tax rate. The bottom line is the percentage of gross domestic product (GDP) that the government has received in tax revenue since the end of the Second World War. The bottom line is essentially flat; the top marginal tax rate has no effect on revenue as a percentage of GDP except in the 1970s when Lyndon Johnson imposed a 10 percent tax surcharge.

Even though the tax rate has declined from 91 percent under Harry Truman, a legacy from Franklin Roosevelt, to 28 percent under Ronald Reagan, the actual percentage of revenue going to the government does not change. This should put to rest the notion that "disastrous Reagan tax cuts" caused runaway deficits. The evidence is clear that the

**Exhibit 1** Federal Receipts and Personal Tax Rates, 1947–1994




*Sources:* Office of Management and Budget; Tax Foundation.

top marginal rate has little or no effect on the government's revenue as a percentage of GDP.

Why is that the case? The top marginal tax rate hits the people in the highest brackets first. They are also the people who have the greatest ability to change their behavior and thereby avoid taxes. The top 1 percent of all taxpayers pay 28.7 percent of taxes. The top 5 percent pay nearly half of taxes. When the top marginal rate changes, they change their investment and spending patterns. Before the Reagan years, the top 5 percent only paid 37 percent. The top 10 percent pay almost 60 percent of taxes; the top 25 percent, almost 80 percent. The top 50 percent pay almost all taxes.

The bottom 50 percent of taxpayers currently pay less than 5 percent of total taxes, and because they are below the marginal rate, they do not have to change their behavior when the marginal rate changes, whereas the top 50 percent can easily change their behavior. All the fiddling Congress does with tax laws to raise and lower taxes causes only changes in behavior and has no real effect in terms of the revenue as a percentage of the economy that the government receives.

The real issue is not how much revenue the government will receive, because we already know that; it gets 19 percent of the economy. The real issue is how fast the economy is growing because 19 percent of an economy that is growing at 3.5 percent per year is more than 19 percent of an economy that is growing at 2.5 percent per year. On that basis, Reagan wins because the economy during the Reagan years was growing at about 3.7 percent per year. President Clinton has said that the most optimistic forecast is that the economy will grow at 2.5 percent per year into the next century.

A tax policy that dooms us to a growth rate of no more than 2.5 percent per year into the next century is a tax policy that guarantees we will have less income. In the business world you know that it is not what price you put on the product that matters. What matters is how much money you have at the end of the year. Sometimes the way to get more money in the till at the end of the year is to cut your prices when you have a slow-moving item. In government that is called supply-side economics. In business it is called intelligent pricing. We do not seem to do intelligent tax planning in the government. We do not recognize that the actual amount that comes in does not make any difference.

There is another issue in Congress that involves a lot of misunderstanding of the facts. What scares everybody is that the century of deficits leads to, naturally, a century of debt. We are told that the debt is running out of control and we must do something about this or it will destroy us. Maybe.

I will return to an example from the business world. When I took over as CEO of Franklin, we had a $75,000 debt. Today Franklin owes the bank $7.5 million. At first glance, it seems that Franklin is headed for absolute disaster. However, what is more important than an absolute level of debt is a relative measure of debt. When Franklin had debt of $75,000, it had sales of $250,000; debt was 30 percent of sales. Franklin now has debt of $7.5 million and sales of $300 million; debt is only 2.5 percent of sales. Franklin also has $40 million in cash but chooses not to use this cash to pay down or pay off its debt because of some prepayment penalties. Franklin's debt is, in fact, quite minimal.

If we look at a century of deficits adjusted for inflation and purchasing power, we see that the greatest deficit occurred in the Second World War. As a percentage of the economy and of purchasing power, we have never had a deficit close to the deficit we had in the Second World War. During the war the federal debt was about 130 percent of the economy, that is, our debt was 30 percent greater than the total output of goods and services in the entire economy. When the war ended, our debt started to fall. It declined in the late 1970s and into 1980 to a little more than 30 percent of GDP; in other words, the total output in the economy was three times the size of our debt.

Today the debt has returned to where it was when Eisenhower was president, but the difference is that it is rising in peacetime, and that has never happened before in U.S. history. Before the current period the debt as a percentage of GDP had always declined in peacetime. We have come to the close of the Cold War, and the debt is increasing. It is not due to lost revenue from President Reagan's tax cuts. It is a function of entitlements.

Eisenhower did not have entitlements. Defense was 50 percent of his budget. Today defense is the lowest percentage of GDP that it has been since 1939. As a percentage of GDP we are spending about as much on defense as we did before we began the build-up for the Second World War. The reason the debt is increasing is entitlements. The exercise we are going through in Congress to try to get some control of the fastest growing and most expensive entitlement, Medicare, is an exercise we must go through if we are going to deal with the debt problem responsibly.

We hear from Democrats that the disastrous Reagan tax cuts caused the growth in the debt and that we need to raise taxes to solve the problem. Others say that the debt is going to bankrupt us and we must solve the problem by cutting spending. Neither solution is correct. The problem will be solved primarily by growing GDP at a faster rate than it has been growing, by cutting spending so that entitlements are not out of control, and by adopting a tax policy that recognizes the stupidity of fiddling with the details.

The major problem with our tax policy is that it is based on the wrong foundation. Where did the 91 percent tax rate come from in the 1930s? Huey Long, senator from Louisiana, the Kingfish, had as his rallying cry "Share the wealth"—every man a king. He based his position on the totally false notion that we had plenty of wealth in this country and what we had to do to solve our economic problems was to share it properly. He assumed that the economy was a zero-sum game. If there is too much money at one end of the economy, you redistribute it to the other end.

Long almost took this issue away from Franklin Roosevelt, but Roosevelt was determined to take the issue back. In the name of fairness, Roosevelt proposed and Congress passed a plan for a graduated income tax with the top rate at 91 percent. Of course, 91 percent clearly is not fair, and Congress created a series of exemptions and deductions. What did the rich do? They behaved in such a way as to take advantage of the exemptions and deductions. Then Congress decided that some of the exemptions were not fair. Congress started calling the exemptions and deductions loopholes and, in the name of fairness, decided to close the loopholes. Congress changed the tax code again. What did the rich do? They changed their behavior again, this time around the loopholes. The bottom line remains stable and we have 300,000 pages of tax code that nobody can read, understand, or properly enforce.

It is time to end the use of fairness as the principal driver of taxes and to recognize that, in the name of fairness, we have produced a system that is both incomprehensible and unfair to everybody. The new watchword should be neutrality. The tax code should not be used for the purpose of setting social priorities. We have other laws to punish the bad guys and reward the good guys. The tax code should be used to raise money for the government.

I realize that is a radical idea, but I suggest that it has to be the foundation of our tax code. The purpose of the tax code is to raise money for the government, which means it should be neutral. It should not encourage people to favor one kind of economic activity over another for tax purposes. People should engage in an activity because it is a sound economic activity, regardless of the tax consequences.

If the tax code is neutral, it will be simple. If it is simple, it can be stable. Neutral, simple and, stable. I believe that one of the great ironies of such a system is that it will turn out to be fair. If you abandon fairness as the grail that you seek, you will get it as a consequence.

An October 24 article in the *Wall Street Journal*, "Capital Gains: Lift the Burden," makes the argument I believe in to support a capital gains tax cut, quite aside from the ideological question of whether it is right or wrong. Lifting the burden of capital gains, or more accurately cutting the rate in indexing capital gains, produces a very interesting phenomenon: more money for the government. If you want to reduce the debt, raise more money. You will not do this by imposing higher tax rates. Another recent article in the *Wall Street Journal* points out the disastrous effects of the 1993 tax increase in terms of government revenue. The article notes that many people do not want to recognize that when the capital gains tax rate is low, the capital gains tax realization, government revenue, is high. In other words, 15 percent of something produces a whole lot more revenue than 28 percent of nothing.

Currently, we have about $7 trillion of capital locked up in investments that will not move because the capital gains tax is too high. If the capital gains tax were lowered, asset holders would begin to sell their investments and move into more entrepreneurial activities. Their investments would be sold to people who are satisfied with a fixed return. More revenue would be generated for the Treasury. The debate should be about revenue and expenditures and not about ideology—whether it is fair with respect to a particular group. We pay our bills with revenue, not with ideology.

# Speaker

## The Honorable Daniel Patrick Moynihan

U.S. Senate (D–N.Y.)

You might wonder how the question of America's prospects in a hazardous global economy would come up at a time when we are a behemoth astride the world. We are the largest economic power, the one military power, one of the most stable political democracies, and the oldest political democracy on earth. Yet, we have to ask about our prospects.

We may be less than three weeks away from defaulting on the federal debt. I recently commented to Secretary of the Treasury Robert Rubin, "The British came here in 1814. They burned the White House. Then they came up here and they burned the Capitol. The president fled into the nether regions of Virginia. Still, we paid the interest on the federal debt." Now we may not make those payments. A crisis is upon us of more than hypothetical order. I would like to talk a little bit about how the crisis developed and how we might get out of it.

The crisis developed in spite of the extraordinary success of economic theory and policy in the twentieth century with regard to figuring out the modes of and route to economic stability. Last spring the Levy Institute had a hugely important conference on a significantly overlooked event, the 50th anniversary of the Employment Act of 1946, an event that has symbolized a transformation of understanding, and in consequence a move from theory to practice, of the experience of the United States and much of Western Europe and the Western world. The change has been dramatic, so dramatic and now so distant as almost not to be known.

In the debate on the balanced budget amendment, I found myself continuously talking to an occasionally listening Senate about the crisis of industrialism that had finally culminated in the 1930s. In the current issue of *The Public Interest*, our thirtieth anniversary issue, there is reproduced from the Joint Economic Committee a chart of the changes in GDP from 1890 to 1990. There are periods of huge ups, downs, booms, crashes, panics, etc. Then in the 1930s it became the judgment of a very large portion of the intellectual world that capitalism was an unstable and unsustainable political and economic system. Then it all came together—the notion of countercyclical financing, the Keynesian redefinition of the process, such that you could have stability at high levels of unutilized resources. The result has been stunning.

Since 1946 we have had only one period in which GDP has gone negative (in 1982 for 10 months). The growth in the cycles does not get much higher than about 4.0 or 4.5 percent. It declines, but it does not go negative; it rises and it declines again. Growth continues in a very solid way. There is growth even as the rate of growth declines. The business cycle has become more meaningful than the economic cycle of a 12-month agricultural economy, which we still have. I found myself talking about this to persons who did not know what I was talking about. The economy has been stable so long that we have forgotten.

A new crisis is upon us, which is the crisis of managing our public finances—the last thing one would expect in the aftermath of a long period of essential economic stability. We are now the world's largest debtor, with the largest trade deficit. Congress will vote today on a massive piece of legislation—2,000 pages—too big to be voted on in 20 hours. It will be vetoed. We will go into a staredown. The ultimate issue is: Will the United States government survive? Where does the crisis come from? It comes from a combination of ideas, an economic reality, and some malfunction in government.

The ideas are an American phenomenon, not something likely to be found anywhere in Europe or Canada. A theme throughout our history is a deep distrust, fear, and dislike of government. However, decades of political minorities' railing against the New Deal, the Fair Deal, and the Great Society had not changed anything. Every so often an election would be lost by the dominant majority, but that majority would come back. Government continued to grow, and disaffections with it grew accordingly.

In the late 1970s opinion began to coalesce around a certain idea. I wrote an article in *The New York Times* in July 1980, saying that the Republican party was becoming a party of ideas. Bill Brock began publishing a quarterly journal of opinion, *Common Sense*. The Democratic National Committee was producing comic books. I said, "Psychologists call this role reversal. As a Democrat I call it terrifying. And to miss it is to miss what could be the onset of the transformation of American politics."

The Republicans' dominant idea seems to be that the social controls of modern government have become tyrannical or, at the very least, exorbitantly expensive. This oppression is made possible by taxation. On the basis of this strategic analysis, cutting taxes becomes an objective in its own right, business cycles notwithstanding. The notion was that if you produce enough debt, you will ultimately incapacitate government. I could relate this idea to Lenin's proposition: The worse, the better. There is much theoretical basis behind it. There are some very elegant formulations in the writings of Nobel laureates from the Chicago School. However, I think it was best captured by the phrase used in the early Reagan White House: Starve the beast.

The Republicans took over a government that had a national debt of about $940 billion, a perfectly manageable debt after 190 years of government. You probably would not want government to have less debt if you wanted to have a certain kind of instrument in the financial market. Fifteen years later we are going to have to raise the debt over the $5 trillion level in a matter of days. The interest on the debt is beginning to consume us.

Then there is the economic reality. During the 1960s, in the era of the Great Society, the federal government took on activities that are singularly afflicted with what William Baumol has called "cost disease." Baumol's disease affects personal services—education, the arts, and, most importantly, health care. It occurs in sectors with low productivity growth and high costs.

You can't play the "Minute Waltz" in 50 seconds; or rather, maybe you can, but then it's not the same piece—it can't take less time than 60 seconds. In the last Congress, during hearings on health care, I asked the dean of a hospital, which opened in 1886 in the Bronx, "When the hospital first opened, how many interns would a professor of medicine on his morning rounds have with him and about how long would rounds take?" He responded that there would be about 11 or 12 interns and rounds would take about one hour. And I said, "And today?" "Gotcha," he said. You can only teach so many interns. You cannot teach 1,000 interns. You cannot do rounds in 12 minutes. It takes time.

Government took on these low-productivity, high-cost activities. There is a tendency for activities with Baumol's disease to migrate to the public sector. That is my addition to Baumol's idea. These activities become untenable in the private sector and, therefore, migrate. An example would be Medicaid. Medicaid doubled in the eight years during Reagan's presidency and also doubled in the four years of Bush's presidency. On December 29, 1996, it doubles in one day and on December 30, it doubles by noon.

Finally, we got ourselves into some mistaken patterns that were the result of a combination of both the liberal impulse and the conservative counterstrategy. As a proven measure, we had been voting increases in Social Security. Every two years there would be a competition in the House and Senate on who was going to raise it the most. In 1972 we voted a 20 percent increase in Social Security. The Nixon administration proposed indexing Social Security benefits to the cost of living. That is sensible and fair. Then in the early 1980s, when a high period of inflation had produced what was called "bracket creep," we indexed revenues—income tax—to the cost of living. We used the consumer price index (CPI) as a proxy for the rate of inflation. The CPI can be ruinous as a proxy.

Last spring we held hearings on this subject in the Finance Committee. We have known there is a problem with the CPI for a long time—at least as far back as 1962, when I was assistant secretary of labor and the CPI was beginning to be used in labor negotiations. The Bureau of Labor Statistics commissioners told us, "That means wages are really going to go up much faster than the actual cost of living." One of the things that probably undid the steel industry was contracts that included the CPI.

The consensus among economists in the hearings was that the CPI is overstated somewhere between 0.4 and 2.0 percentage points. It is not a symmetrical distribution. It is more likely to be in the higher range. A commission that Senator Packwood and I appointed last spring, headed by Michael Boskin from Stanford, former chairman of the Council of Economic Advisers under President Bush, recommended as an interim measure using the CPI minus 1.0 percentage point. If we were to reduce the CPI by 1.0 percentage point, then in 12 years the cumulative effect on the deficit would be a reduction of $1 trillion. I do not know whether we will do this or not.

Our politics now are not very responsive to what we have to do. We know what we have to do. We have to get to a balanced budget. Then we have to buy down the privately held public debt to increase saving. We did have one brief, shining moment in the early summer of 1993. I was chairman of the Committee on Finance. By a very hard-won 50 votes we cut $500 billion out of the deficit—half by raising taxes and half by cutting spending. The results were extraordinary.

The deficit premium, which is what Secretary Rubin describes as the extra that is charged out of the likelihood of monetization when you get too much of a debt, declined. Thus, the debt service went down. Our $500 billion reduction became $600 billion without anybody noticing.

Economic growth has averaged a 3.5 percent annual rate since that time. This is twice the 1.3 percent rate experienced under President Bush. Unemployment is down to about the level that we now think of as full employment, about 5.6 percent (which is higher than we used to think of as full employment but seems to be where the economy should be), and 7.5 million jobs have been created. Inflation is down to about 2 percent, correcting for CPI. Business investment, fixed investment, has increased at a 14.8 percent annual rate, the fastest rate in 30 years. Yet nobody wants this news. We are disavowing it. We are saying, "I didn't want to raise taxes." I did. We had to do it.

We have on the floor today a Republican majority measure, a reconciliation bill. In the midst of a move to reach a balanced budget in seven years, there's a $245 billion tax cut, which is not needed and is not affordable. The time will come when a tax cut is affordable, but not until we balance the budget.

There is a big poll on the front page of *The New York Times* today that tells you all you need to know. The pollsters asked, if you had to choose, would you prefer balancing the federal budget or preventing Medicare from being significantly cut; 27 percent favored balancing the budget and 67 percent favored preventing Medicare cuts. The same question was asked about balancing the federal budget or preventing Social Security from being significantly cut, with similar results; 27 percent chose balancing the federal budget and 70 percent chose Social Security.

This may be the dilemma that liberal social policies always creates. It may be that the advanced welfare states are always broke, but we do not have to be if we can agree to do what we should, by now, know is right. We will go right up to the abyss. The abyss would be default.

I find myself saying in our caucus, "What does default mean?" Default means that the yen becomes the reserve currency, and every retirement system in the United States, beginning with Social Security, is broke. I do not know how this will happen. The prospect of hanging is said to concentrate the mind. But I do not know how good our minds are at this point. We have worked ourselves into this crisis. And in a curious way we thought our way into the crisis. I am not sure we will think our way out.

# Speaker

## David A. Levy

Vice Chairman and Director of Forecasting,
The Jerome Levy Economics Institute

### U.S. Trade Deficit: Global Time Bomb

I would like to talk to you about an economic problem that threatens both domestic and global stability yet is widely ignored: the nation's foreign indebtedness. This situation is a time bomb, and there may not be much more time on the delayed fuse. We seem to be good at projecting unfavorable consequences of our growing federal debt but to be blind to those of our foreign debt. Despite abundant public discourse on the costs of the United States's trade deficit—how it drains income and jobs from this country—the effects of *repeated* trade deficits on America's foreign debt are overlooked. If current trends in U.S. international trade continue, the swelling debt will cause a global currency crisis and severe economic disruptions in just a few years, maybe much sooner.

The consequences of America's rising foreign indebtedness are the subject of a recent Levy Institute *Public Policy Brief* by Distinguished Scholar Wynne Godley, who came to us via Cambridge University and the British Treasury. The foreign debt problem easily merits all the time I have to speak to you today, but I also would like to discuss a broader problem, of which the foreign debt situation is a prime illustration: There is a serious disconnect between much of the public policy debate in this country and economic reality. America's public officials often have failed to understand and at times even to identify the nation's major economic problems. The primary blame belongs to the confused state of the discipline of macroeconomics.

The field of economics is like a buffet. You grab a plate and choose from a rich and varied bounty. There are four basic sections.

First, there are vast assortments of data in all-you-can-eat volumes. However, the quantity is often superior to the quality.

Second, there is the best of the buffet—large quantities of appealing, well-prepared logic and reason, with occasional lapses by the chefs.

Third is the somewhat trendy and ever-growing assortment of econometric and other quantitative techniques for modeling and analysis. These are not infrequently misapplied, overextended, or undermined by the poor quality of data. When they are, they bear out the old computer adage that is equally true in cooking: Garbage in, garbage out.

Fourth, and often the most memorable part of the buffet, is a generous spread of assumptions and articles of faith best described as religion. The conclusions of economic models are largely predetermined by the assumptions they are based on. Where the facts leave off, beliefs fill in, and sometimes beliefs displace the facts. The faithful of the various religions often believe that a great many of the economy's problems can be solved by accommodating their gods, to whom they attribute great powers that go well beyond, or even fly in the face of, objective analysis.

Also notable is what is missing from the buffet or, at best, present in small quantity stuck in among the condiments: dishes from other social sciences. The chefs are resistant to incorporating the cuisines of other disciplines. The most striking recent example was the simplistic advice of some economists to newly ex-communist countries—advice that ignored the legal institutions, culture, and historical precedents that, along with market structure, would determine the success or failure of newly liberated economies. Another example is the insistence of economists on assuming that businesses behave in certain ways in spite of what theorists, scholars, and practitioners of business strategy and management tell us.

Economists file past the buffet table, heap onto plates varying combinations of data, logic, mathematical procedures, and assumptions, and then offer them to the policymakers. What they present often looks like one big pile of glop. It may smell good or it may not, but either way, it is hard for policymakers to peer through the mathematics or to separate the religion from the facts and analysis. And, in fairness to economists, politicians often add a hearty serving of their own religions.

For more intelligent public policy debates, there needs to be a clearer line separating what we know is true and what many believe is true without decisive evidence. The foreign indebtedness problem, to which I will now turn, is a spectacular case of unrealistic assumptions.

The foreign indebtedness problem, in short, is that when a country runs deficits, its indebtedness rises, which in turn increases its interest payments, which contributes to still larger deficits. The greater the debt, the greater the interest bill and the more difficult it becomes to eliminate the deficit. We all know about this process—our federal government is an infamous example. The federal government would have been running a surplus of about $60 billion in 1995 if it were not for the need to pay $230 billion in interest on the debt. Similarly, the longer the United States runs trade deficits, the larger our international debt will become and the larger our interest payments to foreigners. If this process is not interrupted, then at some point it must break down, and the dollar's foreign exchange value will plunge.

Let's take a closer look. In 1970 the United States's net foreign holdings were $300 billion, or 30 percent as large as GDP. We earned more interest, dividends, and profits from our overseas holdings than we paid to foreigners as earnings on their American assets. We had a "factor income" surplus or, more informally, an investment income surplus. The investment income balance is one of the three components of the current account balance, the others being the balance of goods and services and the balance of unilateral transfers, which include government foreign aid and private gifts. During the 1970s the United States's merchandise trade surplus, which had persisted for virtually the entire postwar period, gave way to chronic deficits. Still, the merchandise trade deficits were substantially or entirely offset during most of these years by surpluses in services and investment income.

But the trade deficit continued to widen, and in the early 1980s it tipped the current account balance into deficit, where it has remained virtually ever since. What did that mean? We were paying foreigners more than they were paying us for goods, services, foreign aid, and for the use of capital. *We were losing wealth to the rest of the world.*

America kept running current account deficits through the 1980s, and the country's net asset position dwindled. In 1989 America became a net debtor. After years of buying more from abroad than we were selling—after years of losing wealth to foreigners—America was going deeper and deeper into debt. This event triggered a brief period of hand wringing, speeches by politicians, editorials, and finger shaking by economists. But since then the foreign debt largely has been forgotten. Even during this past spring, when the dollar fell sharply, most of the Wall Street analyses did not even mention it.

When America first became a net debtor, we did not start running an investment income deficit right away because we were earning a higher *rate* of return on our foreign assets than foreigners were earning here. But U.S. indebtedness kept growing, and foreigners accumulated more American financial assets. Finally, in the fourth quarter of 1993, the United States began to run an investment income deficit (on a National Income and Product Accounts basis; two quarters later on a balance of payments basis). Few people seemed to notice that the current account deficit now reflected two serious component deficits, a large one in trade and a new one in investment income. Since then, the investment income deficit has continued to grow, helped along by the Federal Reserve's 1994–95 interest rate hikes, and it exceeded $20 billion (annual rate) in the latest period.

The United States has a problem because the debt is growing faster than GDP. In fact, it is no contest. Presently, the net foreign debt is growing about 25 percent a year. An extreme hypothetical example shows why this situation is unsustainable.

Suppose that the 1995 net foreign debt was 100 percent as large as GDP, or $7 trillion, and the rate of interest on this debt was 6 percent, so that the investment income deficit was $420 billion. Now, let's further suppose that the goods and services trade deficit and the unilateral transfers were together $180 billion, which is roughly what they have been lately. Then the current account deficit would be $600 billion. The United States would have to borrow $600 billion from foreigners during the year, close to four times the current federal deficit! And next year, the debt-to-GDP ratio would be even bigger! It is hard to imagine how the dollar would not plunge as the market perceived an advanced case of "Ponzi finance," to borrow the term from Hyman Minsky, distinguished scholar at the Levy Institute.

Neither Godley nor I believe this extreme case will ever come about because markets will not let matters go nearly so far. But the United States is headed in that direction faster than one might think. Net foreign debt is near 11 percent of GDP, up from 8.7 percent last year. Godley shows that with the trade deficit plus unilateral transfers holding at 2.5 percent of GDP and with the addition of some moderate assumptions about growth and interest rates, the net foreign debt will equal 24 percent of GDP in the year 2000 and 51 percent of GDP in 2010. These figures are not intended to predict the magnitude of the future debt but, rather, to show that the forces for a severe market adjustment are building fast. The longer the net foreign debt outpaces GDP, the more dramatic the inexorable correction.

Some economists have dismissed America's swelling foreign indebtedness. They say that if enough international investors decide that they have too many dollars or that America's debt is a threat, they will sell dollars; the market will adjust. This view misses the point entirely. The concern is not that markets will not adjust, but what will happen when they do. Markets already have allowed the imbalances to become so great that when they finally do adjust, dramatic price and currency realignments are almost sure to occur, jolting financial institutions and the global economy.

Many of those who dismiss the foreign indebtedness problem typically do not see the adjustment as a serious threat because they make unjustified assumptions. Their international models assume free trade and conditions that guarantee full employment equilibrium. They take for granted the smooth, efficient functioning of financial institutions, ignoring, for example, the effects on the balance sheets and solvency of international banks when many of their assets are in dollars that lose value. These models also assume that investors move capital around the world based on rational assessments of expected returns on assets without getting caught up in manic, pathological speculation. These economists further assume that their theoretical models, while idealized, are a good approximation of the real world. They assume that the real-life market has sound reasons for what it does, so they do not expect America's foreign debt to be a dangerous problem.

But competition comes in varying degrees of imperfection, and some markets are much freer than others. There are issues of protectionism and structural barriers, such as those that have been the subject of our trying negotiations with Japan in recent years. There are selective trade policies catering to political motives, such as China's practice of granting market access to foreign firms only when they offer to transfer technology or when their governments abstain from criticizing China's human rights record. If trade really were perfectly free, GATT and World Trade Organization negotiations would have been a lot less contentious.

In short, markets have their flaws, and unsustainable trends can keep going for a very long time before corrections occur. The 1980s Latin American debt crisis serves as a striking reminder.

The assumption that market discipline keeps the financial sector healthy is also faulty. Severe, systemwide problems have afflicted financial institutions: the epidemic bank failures of the early 1930s, the savings and loan debacle of the 1980s, and the "credit crunch" of the early 1990s (the result of real estate deflation and unusual loan problems throughout the banking system).

Presently, the huge holdings of dollar assets on many foreign financial institutions' balance sheets are daunting. If these assets fall in value because the dollar declines sharply against the yen and major European currencies, there is danger of widespread defaults, insolvencies, and unfavorable global economic consequences. Consider Japan's troubled banks, which have already been hurt by the dollar's decline, among other things, in several ways.

1. The value of their dollar loans has declined.

2. The exports and profits of many of their Japanese loan customers have fallen, creating domestic loan problems.
3. Domestic investment in Japan has fallen, partly because labor costs are now high in the wake of the yen's rise, weakening the economy and causing still more loan problems.
4. These problems have further weakened the real estate market, undermining mortgage loans.

A plunging dollar might cause severe financial problems that force Japanese and other institutional investors to liquidate dollar assets in a panic. In such a crisis the market might decide that the dollar was no longer trustworthy as a reserve currency, leading to a dollar rout.

The U.S. foreign debt situation is both seriously out of balance and unsustainable—an adjustment must come at some point. To restore a reasonable balance, the market must more or less eliminate the U.S. trade deficit and do it within a few years. Unless the adjustment occurs soon and gradually, it will in all probability cause considerable damage to the global financial system and to individual economies.

There are two ways imports are usually reduced when a country's debt grows too large: through a drop in the value of the currency or through a drop in domestic demand (a recession or depression). Based on the size and stubbornness of our trade deficit, a steep dollar decline or a contraction of the U.S. economy that pushed the unemployment rate to perhaps 10 percent would be necessary to bring the trade deficit to zero. However, the world economy, which already has severe vulnerabilities, probably would be unable to absorb the huge loss of export sales without a global recession, which would hinder U.S. exports and require further cutbacks in our imports. Meanwhile, the dollar's drop would aggravate international financial problems, adding to the economic mess. A downward spiral into global depression might occur.

Are there any policy alternatives? Yes, although there is no simple formula. We should do everything possible to reduce our current account deficit without causing a recession or accentuating the downward pressures on the dollar. Let me suggest a few.

1. Do not try to delay the market's inevitable correction by pushing up the dollar because that will lead to even greater pressures for a future decline. If the dollar's fall in late 1994 to early 1995 was the market's attempt to correct global imbalances, what on earth were the Federal Reserve and the Treasury doing helping Japan and Germany fight the market?
2. Persuade the surplus countries that it is in their interest to stimulate their internal economies. It is better for them to begin reducing their reliance on trade surpluses with the United States than to have this key support of their economies abruptly removed by a crisis.
3. Continue to fight to remove barriers to U.S. exports in other countries.
4. The Federal Reserve should avoid excessive domestic interest rates. Our country's foreign debt is almost entirely in our own currency, so when our interest rates rise, we pay more interest to foreign countries. And, of course, high rates boost the dollar.
5. Godley points out that a provision in the World Trade Organization agreement allows a nation "in order to safeguard (its) external position to restrict the quantity or value of merchandise permitted to be imported." Key requirements are that the policy be nonselective and nondiscriminatory—applying to all goods from all countries. Thus, an across-the-board tariff could have the same effect on imports as a dollar depreciation, without a negative impact on international dollar assets. This tactic, which should be distinguished from protectionism, should be explored along with any other reasonable options.

Godley's contribution is in calling attention to the foreign debt problem, not in revealing the perfect solution to it (and he would agree with this assertion). Our best hope is that the governments of the United States and the major surplus nations will recognize that it is in everyone's interest to reduce the U.S. trade deficit smoothly before markets shrink it in a more disruptive manner.

The indebtedness problem is a prime example of how our policy debates can miss the central issue. Many economists are reluctant to look outside of their models for explanations for the trade gap, so they downplay issues of protectionism, mercantilism, currency manipulation, and so forth. They charge that the trade gap reflects our own profligacy—that our low personal saving and, especially, negative government saving have forced us to rely on foreign saving. How? It is claimed that the federal borrowing and low personal saving bid up interest rates, thus causing a strong foreign demand for dollars, which in turn causes international investors to bid up the dollar's foreign exchange value, which gives foreign firms a competitive advantage over U.S. firms. *Voilà*: a trade gap.

As I will explain momentarily, this is a monstrous abuse of one of the most basic laws of economics: saving equals investment. Yet the popularity of this line of reasoning, which is taken as irrefutable by some of our brightest and best-meaning government officials, has diverted much of the trade deficit debate into the federal budget debate. The trade problem lately has gotten a bit more attention on its own merits only in light of new evidence: the trade deficit's persistence in spite of lower interest rates and a weaker dollar, changing perceptions about Japanese domestic markets, a swelling deficit with China, and evidence that U.S. industries are overall the world's most productive and competitive.

I would like to talk more broadly now about how many economic policy discussions go off target. If I had to pick one source of the problem, it would be the saving-investment relationship. This relationship is what is known as an "identity" because the terms must be equal at all times by virtue of the way they are defined. That saving equals investment is an irrefutable fact, yet people draw all kinds of nonsense from it.

All that saving equals investment means is "The wealth society creates equals the wealth society acquires" —a simple tautology. Saving and investment both refer to changes in wealth. The process of *acquiring* wealth is called saving. The process of *creating* wealth is called investment—the production of tangible assets, such as structures and capital equipment, that will increase the production of goods and services in the future or goods in inventory that will be consumed in future periods.

This tautology is contorted in amazing ways because people make two errors in applying it. The first major error is when saving equals investment magically becomes saving *causes* investment. This is sometimes further convoluted to saving *finances* investment. Indeed, this phrase has a nice ring to it and goes over well as a TV sound bite, at cocktail parties or fund-raising dinners, and on the campaign trail, just as long as you don't complicate the discussion by bringing up money supply, the Federal Reserve, or the banking system. Just hope no one asks, "If saving is the supply of funds, what is the money supply?"

Indeed, the availability of funds to finance investment is the province of monetary policy and the Federal Reserve. If the Fed supplies liquidity, that is, provides the banks with adequate reserves to make more loans, then investment will be financed regardless of how much you save, I save, or anybody else saves. Indeed, it is the decision to invest that generally causes both saving and investment. Create wealth, and someone will acquire it.

Consider what happens when a firm borrows $1,000,000 from a bank and purchases a new machine. The bank creates the million dollars as it is empowered to do by the Federal Reserve based on its available reserves. The firm thus invests, and no one had to decide to save. Where is the saving? The firm has no change in its wealth—the new million dollar asset balances the million dollar debt. But the machine maker will save some of that million as profit; the workers who built the machine will save some of it when they are paid wages; and the part of it that workers spend becomes profits, personal saving, or tax receipts elsewhere in the economy. The million dollar investment caused a million dollars of saving.

The second major error in applying the saving-investment identity is that saving equals investment becomes personal saving plus government saving plus foreign saving equal investment. Anyone familiar with the saving-investment identity who does not immediately spot what is wrong with this equation is living testimony to the success of the propaganda effort. The problem is that this statement omits the most dynamic and most essential kind of saving in a capitalist economy—business saving, or profits after taxes and dividends.

The omission of undistributed profits represents a pinnacle in the creativity of economic theorists. According to the leading economic theory, profits have the remarkable feature of motivating every move businesses make and simultaneously not existing. The trick is that economists' profits, unlike accountants' profits, are typically defined to mean profits above and beyond what is needed to cover the investors' cost of capital. Based on the assumptions behind the model, profits, so defined, will equal zero when the economy is at equilibrium, and the economy is always gravitating toward equilibrium, so aggregate profits will tend toward zero. Presto, no more profits!

But profits exist, and sharp changes in profits induce businesses to make major shifts in employment, production, and investment. In fact, the saving-investment equation can be flipped a bit to yield a profit identity: profits after taxes and dividends equal business saving equals investment minus personal saving plus government deficit minus foreign saving.

This identity is written as if changes in *personal* and *government* savings impact profits, not investment. Identities do not tell us what causes what, and in fact there are a number of complex interrelationships within this identity. Nevertheless, I and others have argued strongly that the primary causality is toward profits—that business investment decisions, household saving decisions, government fiscal policy, and decisions by Americans and foreigners on whether to buy American or foreign products all largely determine business profits. After all, businesses can't make "profit decisions"; they take what they can get. In other words, the profit identity can be interpreted as a statement of the sources of profits. This is not an idle comment; three generations of my family have employed this perspective in analysis and forecasting for 80 years with considerable success. Indeed, that success is why there is a Jerome Levy Economics Institute.

There are even more ways to view the saving-investment identity. Suppose we take saving equals investment and break investment into two parts, domestic investment and net foreign investment. The Bureau of Economic Analysis does. In the BEA's saving-investment Table 5.1 in the National Income and Product Accounts, there is no term, "foreign saving." Instead there is "net foreign investment," which is essentially the current account surplus. Using saving equals domestic investment plus net foreign investment, we see the current account deficit not as saving but as negative investment, a loss of wealth to foreigners. We should not be grateful to foreigners for providing saving, but bothered that they are reducing investment and therefore saving, draining wealth from our economy.

This is not how many people look at our economic problems. Fallaciously thinking that saving finances investment and that business saving is nonexistent, they conclude that personal saving plus foreign saving minus the government deficit determine investment. Investment has been weak for much of the past 15 years—for reasons having nothing to do with saving. (This phenomenon is the subject of Jay Levy's and my forthcoming book.) But many people have advocated policy changes to raise saving and therefore, they hope, investment—deficit reduction, incentives to increase personal saving, and measures to support the dollar to attract foreigners' saving.

There are many good reasons to cut the federal deficit. The federal debt–to–GDP ratio shouldn't grow continuously over time, and it is larger than we would like it to be. There are also legitimate reasons to want to reduce certain federal programs and to make bloated bureaucracies lean and mean. There are social choices to be made about the size and scope of government that do not relate to economics.

There are also good reasons to want Americans to save more. Many people lack retirement security and financial cushions to see them through rough times. And there are advantages to a strong dollar.

But the idea that attaining these saving objectives will increase investment is nonsense. They will just lower business saving—profits—which will hurt future investment. Before we pass tax reform or determine how much federal spending to cut, we had better reconsider the reasons for these changes.

I would like to end with a story. A submarine carrying two men hit an underwater mountain and slowly began taking on water. Water kept spraying in through a crack in the floor, and air kept bubbling out through a crack in the ceiling. As the water inside rose from ankle deep to knee deep, one man cried, "My God, if this water keeps pouring in, we'll drown. We must find some way to stop it!"

The second man replied, "No! No! No! You don't understand the problem. The air is rapidly seeping out through the ceiling. If it were not for the water coming in to fill the space, the air pressure would drop until we died. Thank your lucky stars for that water coming in, and pray it doesn't stop!"

The second man was a Wall Street bond analyst. He spent much of his time fretting about what would happen if the Japanese decided not to invest in the United States. Interest rates would soar, he was sure. After all, saving must equal investment, and American saving alone had been inadequate to "finance" American investment for years. God forbid the foreigners should stop increasing their U.S. holdings!

In reality, that saving—the result of our current account deficit—should be about as welcome as the water gushing into the submarine. Too many people take the saving-investment equation and arrive at preposterous conclusions using Marxian logic (Chico Marx). They would have us believe that foreign saving is something that international investors kindly and graciously offer us so that we can support our bad habit of saving too little on our own to finance our investment. In fact, our trading partners are siphoning off wealth we produce.

We have reached a critical juncture in international economic history. We can blind ourselves with erudite nonsense and allow a calamity to unfold, or else we can make sure the models we employ really do fit the problems to which we apply them. America can no longer afford to formulate policies according to a mistaken model of the global economy. Nor can our trading partners afford to let our present trade patterns persist—whether they realize it or not. The time bomb is ticking, and the time to defuse it is now.

# Forum

## National Economic Policy for 1996 and Beyond

A synopsis of remarks by

**Judy Woodruff** (moderator)
Prime Anchor, CNN

**The Honorable Amo Houghton**
U.S. House of Representatives (R–N.Y.)

**Barry Rogstad**
President, American Business Conference

**Gene Sperling**
Deputy Assistant to the President for Economic Policy

**Barry Rogstad** offered a private sector perspective on the recent budget and tax proposals and their implications for sustained economic growth over the long run. He stressed the importance of sustaining economic growth with a focus on saving and investment. Rogstad asserted that when business analyzes budget and tax proposals, it tends to focus on the proposals' effect on saving and investment because it views saving and investment as the determinants of future economic growth. National saving, he said, which was between 8 and 10 percent of GDP during the 1960s, has declined to 3 to 4 percent today, with an increasing share being absorbed by the national budget deficit. The low level and the absorption by the deficit leave a declining share of saving (now about 2 percent of GDP) available for private sector investment, which results in restricted productivity and economic growth.

Rogstad contended that the tax code is the major culprit behind the low level of national saving and the resulting diminished supply of funds for private investment. He predicted that reform of the tax code is likely to be a combination of the Armey flat tax and the Nunn-Domenici U.S.A. tax. Of the tax proposals currently being discussed, he believes that only the Nunn-Domenici proposal has the goal of removing from the code the existing bias against saving. Moreover, he said, the low level of national saving makes the United States dependent on foreign saving to make up the shortfall; growing dependence on foreign saving will eventually reach a point where it will become "unhealthy" for the United States.

Rogstad emphasized his concern that the current federal budget outlays and the tax code subsidize the present at the expense of the future. In the budget, for example, current outlays represent a transfer of resources to the elderly from current workers explicitly and from the young implicitly. Specifically, 50 percent of noninterest and nondefense outlays go to the elderly. This same bias is present in the tax code, which assesses saving twice relative to consumption. To remove this bias, Rogstad suggested taxing consumption and saving in a more neutral way. He supports the Nunn-Domenici proposal because it taxes all income once, taxes all income the same way, and defers taxes on saving until that saving is spent.

**Gene Sperling** affirmed that the administration's ultimate goal is to have a more prosperous country that allows for a broader middle class. He added that there is no simple way to determine what is best for the country and no single policy or action that can cure its problems. Lowering the budget deficit is the best means to increase net national saving and therefore the investment pool. However, as important as increasing saving is, policymakers cannot ignore the importance of investing in education and training. The president and Republicans agree on the need to balance the budget and increase saving but differ on how to achieve these goals.

Sperling expressed his disappointment that so little of the policy debate in Washington is actually about policy or policy goals. An enormous amount of time is spent arguing, for example, about classification of items as either fees or taxes, and not whether the imposition of those fees or taxes represents a good or a bad policy. He defined the ultimate goal of policy as "a more prosperous country that allows for a larger and stronger middle class, where more and more people have the chance to work their way up, . . . have some security, and spend time with their family." Accomplishing this goal requires not necessarily redistributional policies, but rather policies that increase the size of the economic pie. Moreover, policymakers need to set goals that take into account many integrated components, such as the budget deficit, national saving rate, education, crime, and health care. A focus on only one area cannot be a means of curing all the nation's ills. Unfortunately, good public policy runs counter to "good message politics," that is, selecting one message—in this case one area for reform—and repeating that message over and over again.

The administration has chosen to promote a more integrated policy, focusing on budget and investment deficits. The reduction of the budget deficit does not appear at this time to be the best means to raise the net national saving rate. According to Sperling, education and training are crucial as means of strengthening the economy and, therefore, increasing the national saving rate. Goals 2000, school-to-work programs, and direct lending programs would be an important start in addressing the educational investment deficit. So far, there has been tremendous progress in reducing the deficit without having to undermine the other structures necessary for a more productive country. Says Sperling, the administration agrees with Republicans about reducing the deficit and about increasing national saving as a primary economic goal; how you accomplish those goals is, however, critical.

Sperling noted that in order to compare the administration's budget proposal and the Congressional proposals—including differences in spending on education (a $40 billion increase over the next seven years in the administration's budget and a $36 billion reduction in the Republican plan) and the Republican proposal to reduce the earned income tax credit—the Republicans' proposed reductions need to be put in context. The Republicans are proposing the reductions at the same time that they are proposing to cut taxes by $245 billion while raising taxes on working Americans by $42 billion. According to Sperling, reductions are not being proposed for the "higher purpose of balancing the budget" or even to give the middle class a break, but for the purpose of offering a $245 billion tax cut, instead of a $202 billion tax cut. He added, "Money is fungible, and the choices we make say a lot about our values."

**U.S. Representative Amo Houghton** addressed four topics: the debate over a balanced federal budget, which he favors; the prospects for tax reform, which he doubts will occur during the 104th Congress (and probably not until 1997); the expected state of the national economy, which he sees as good; and the potential effect of these issues on the 1996 election, which he sees as important. Houghton stated that Congress wants a budget that is not only meaningful and acceptable, not only arithmetically correct, but also caring. He noted that although it is likely that President Clinton will veto the budget resolution, Congress and the president agree on much and could reach a compromise. Both want a balanced budget, reductions in Medicare, and a tax decrease (which Houghton opposes). Although Congress's budget resolution is not ideal, at least, according to Houghton, it represents a move in the right direction and gets change started. With military spending, interest, and Social Security off the table during this budget debate, entitlement spending, such as Medicare, is a necessary target for reform.

Houghton noted that the ingredients are in place for a budget agreement but that an agreement is not likely to occur before December. He opposes tax reductions at a time when budget cuts will hurt individuals and feels that criticisms by Democrats of Republican budget proposals are disingenuous, since the Democrats themselves have proposed a tax cut. He stated that the current proposals may not be the best way of solving current problems, but at least they represent movement; problems that arise can be corrected later, but doing nothing will not solve anything.

In addition, Houghton asserted that the Republicans' proposed budget reductions would not act as a drag on the economy, given the size of the cuts relative to GDP and the seven-year term over which those cuts are to be implemented. The size of deficit reduction (relative to GDP) is also small in comparison to other times when such actions were taken, such as during the Eisenhower and Johnson administrations.

Proposed changes to the Medicare system that will encourage beneficiaries to enroll in HMOs or similar types of programs will help reduce costs, keep money in surrounding communities, extend the term of financial liabilities, and allow people to work together who have not been allowed to do so because of antitrust laws. Houghton noted that the

CBO has estimated that such enrollments in HMOs will increase to about 25 percent within the next seven years; he felt, however, that the percent of Medicare recipients enrolled in HMOs at the end of the seven years would be higher than 25 percent.

Houghton acknowledged that many Democrats and some Republicans have problems with the switch to provider-care programs because of their possible effects on the availability of health care in rural areas and on hospitals. These concerns may be justified, and some hospitals in smaller communities may go under. However, he said, provider-care programs bring incentives into the Medicare system by reintroducing the relationship between those who pay for services and those who receive them. Congress will not turn its back on health care after this vote, but will monitor the situation.

**Judy Woodruff** moderated the forum and asked the participants to assess the near-term difference in the economy if President Clinton's tax cut of $105 billion or Congress's tax cut of $245 billion were adopted. More important than the dollar amount of any tax cut, responded Houghton, was the state of the economy. Rogstad agreed and stated that the psychological effect of a cut is more important than its level. Sperling commented that if the Republicans adopted Clinton's tax cut, enough funds would be available to meet Clinton's education goals and nearly meet his Medicaid goals.

Next, Woodruff asked what questions are going to be asked in moving toward a resolution of the Medicaid debate. Houghton noted that an important question was how many people would lose coverage under the block-grant approach. Sperling asked what happens to "people's health care when you cut $182 billion and set off 50 separate state battles between powerful health care lobby interests and disadvantaged children." Responding to Sperling's comments, Houghton remarked that a reduction in the growth of dollars would not necessarily have to lead to a reduction in care.

# Panel Discussion

## U.S. Economic Prosperity Within the Global Perspective

A synopsis of remarks by

**Susan Dentzer** (moderator)
Chief Economics Correspondent, *U.S. News & World Report*

**The Honorable C. Christopher Cox**
U.S. House of Representatives (R–Calif.)

**The Honorable Lawrence B. Lindsey**
Member, Board of Governors of the Federal Reserve System

**Joseph Minarik**
Associate Director, Office of Economic Policy of the Office of Management and Budget

**The Honorable June E. O'Neill**
Director, Congressional Budget Office

**Susan Dentzer** introduced the session with the observation that "We are now engaged in what appears to be a kind of fiscal Gettysburg here in Washington, a great and probably not very civil war about whether and how to balance the federal budget and eliminate the deficit over the coming seven to nine years." She commented that although balancing the budget and eliminating the deficit are the goals of this government, the economic reasons for wanting to achieve these goals are often left out of the political debate. The political debate focuses on reducing the role of government instead of on the actual economics of such actions. This curious omission is regrettable because how the budget is balanced is probably as important as its being balanced. Dentzer listed several important questions that require attention.

- Is how you balance the budget as important as balancing it?
- How do spending changes affect income inequality?
- What are the domestic and global effects of balancing the budget?
- How will reducing the deficit affect national saving and will any resulting change in saving be limited to the domestic economy?
- What will happen to the value of the dollar as a result of budget balancing?
- If we do succeed in balancing the budget over the next seven to nine years, what will our fiscal state be in the longer term, for example, when the baby boomers retire?

She noted that economists disagree about the answers to these questions, and the public discourse about many, if not all, of these issues is insufficient in the broader public policy arena. For example, even if all Medicare reforms proposed today are enacted, they would be only a beginning in solving the problem of runaway costs; what would have to be done after this?

**Lawrence B. Lindsey** remarked that growing interest in the U.S. dollar is a worldwide phenomenon that he attributes to the large political and economic shifts experienced around the globe. He posited that the world is in a period of policy conflict in which there is no ideal world currency. As a result, there is instability in international currency and international trade markets. The U.S. currency is the natural one to fill this void. The United States, he said, must increase and sustain the credibility of its fiscal and monetary policies to win worldwide confidence and achieve this goal. Both inflation expectations and political forces can influence the value of exchange rates. Exchange rates tend to be lower than they otherwise would be in countries with highly variable electoral politics or with exchange rates and inflation policies that vary with electoral outcomes or fiscal policy.

According to Lindsey, credibility must be homegrown; it cannot be imported. There has been increased credibility in U.S. monetary policy over the past 15 years. He stated that the United States was within one or two business cycles of attaining effective price stability and that reducing the fiscal threat to monetary policy will help bolster the political credibility of an antiinflationary policy.

Currencies function, Lindsey said, as a store of value and as a useful medium of exchange. To some, maintaining a currency as a store of value has a philosophical base, with the currency representing a moral contract between government and people. To most monetary policy practitioners, however, money is a pragmatic policy matter, with the value of a currency, like the price of goods and services, merely something that fluctuates. This view is the dominant one behind monetary policy practice today.

Lindsey noted that it should come as no surprise, then, that abandoning responsibility for currency as a store of value has repercussions. First, the freedom to set inflation rates has the trade-off of requiring a politically acceptable inflation rate. Second, investment, particularly portfolio investment on a global scale, may be less than it otherwise would be.

According to Lindsey, setting a politically acceptable inflation rate has its own associated problems. Purchasing power parity poses that the difference in the value of two currencies reflects different inflation rates. In reality, however, inflation rates vary over the business cycle. Currency holders know that the variance in a country's inflation rate is a function of its mean rate of inflation. Holding a high-inflation currency is therefore riskier than holding a low-inflation currency, and holders of high-inflation currencies will come to expect a premium for the associated extra risk. Being a high-inflation currency carries a burden of higher interest rates on the nation's debt. Varying inflation and exchange rates also can result from changing political forces, thereby injecting a random element into the exchange rate calculation.

The second potential problem arising from abandoning currency as a store of value, Lindsey says, is that it may create an environment less attractive to investors. Such an environment could result if people expect that a currency will depreciate in the future or if the government may, over the intermediate term, attempt to ameliorate fiscal problems by raising taxes on capital. Either phenomenon would tend to reduce capital inflows from abroad and, particularly in the latter case, to increase capital flight.

Antiinflation credibility, then, is vitally important in Lindsey's view and, once lost, is difficult to regain. Such credibility must come from a fundamental conviction borne out by experience that the central bank will do the right thing and that the political process will support or at least not undermine that policy. As long as the nation maintains a steadfast commitment to fiscal responsibility, the U.S. dollar will reemerge gradually as an ideal currency. Faith in the issuer, and all the attendant advantages to our economy and global trading arrangements, will help make the world a safer place.

**U.S. Representative C. Christopher Cox** noted that the White House agrees with Congress that a balanced budget is an acceptable goal, although it had, until very recently, disagreed with the time period within which it should be achieved. Current disagreement, he said, stems from whether CBO or OMB economic estimates should be used in determining budget figures. The administration and Congress are, nonetheless, moving closer to an agreement.

Cox stated that how the budget is balanced is a more important question. Should it be done at a high level of taxes and spending or at a more moderate level of taxes and a more restrained growth rate of spending? The current entitlement system virtually assures that federal spending will rise. The Bipartisan Commission on Entitlement and Tax Reform, on which Cox served, deemed the current spending trend unsustainable. Accordingly, Congress is attempting, in a very modest way, to effect change.

Bringing about that change is difficult, as Cox sees it, because "an old system" is still intact. Although "revolution" seemed to be the order of the day after the elections in 1994, in some significant respects things have not changed much. Policy is still based on theory and models rather than empirical evidence. For example, despite empirical evidence to the contrary, many still assert that cutting the capital gains tax rate would result in lost revenue or, at best, a one-time increase in revenue followed by declining revenue. Because theory tends to be more important than real-world evidence, Congress still must score a cut in the capital gains tax rate as though it would result in revenue loss. This reluctance to stray too far from the prevalent model hamstrings the pursuit of growth policies that would make America more competitive.

According to Cox, we also are hamstrung by the burden of government on productive workers, savers, and investors. In the 1950s government consumed 20 percent of the GDP, the average household's income tax rate was 2 percent, the FICA withholding rate was 1.5 percent, and the 30-year mortgage rate was 4 percent. We had a balanced budget and a low tax rate because there was no welfare state to support. If we want to look toward a future for our children similar to the future our parents looked to for us in the 1950s, we must come to grips with the unsustainable trends in entitlement spending.

**Joseph Minarik** addressed the question of how the United States might prosper in an increasingly interconnected world economy. One prerequisite for U.S. prosperity, he contended, is that the rest of the world prosper. Although as nations develop they become competitors, they also become consumers of U.S. goods and services. Nations specialize and tend to develop unique skills and advantages. Such nations export and import more, building on relative strengths in production and enjoying lower-priced products and services in the areas of relative weakness. According to Minarik, the United States can maximize its strengths and minimize its weaknesses by increasing national saving as well as investment in physical, human, and intellectual capital, both public and private. This, he asserted, will increase U.S. competitiveness.

Minarik stated that the only factor that is sure to lead to long-term prosperity is a reduced budget deficit. Lower deficits will increase the amount of capital available to the private sector, thereby giving the private sector the tools that it needs to prosper. Minarik noted that the budget deficit declined during the Clinton administration from 4.7 percent of GDP in 1992 to 2.3 percent in 1995 and is now the lowest among G-7 nations.

The U.S. trade deficit is, according to Minarik, "a problem area," but should be viewed in the appropriate broader context, namely, that since the U.S. economy is growing, it can be expected to import more, which puts upward pressure on the trade deficit. In contrast, stagnating countries import less, and their trade deficits decline. Growing economies help stagnating economies to increase their production and get back to full employment by purchasing their goods and services.

The United States has been growing faster than the rest of the developed world, which is part of the reason it has been importing more. U.S. trade competitiveness has improved, with the U.S. share of world exports rising to 12.5 percent in 1994 as compared to 11.7 percent in 1990 and 10.6 percent in 1987. The United States is successful at exporting; what it now needs is stronger growth in other countries so as to increase the total volume of trade, which will, in turn, result in a more prosperous U.S. economy. Minarik acknowledged that how that growth might be spurred is not easy to determine.

**June E. O'Neill** addressed how reducing the budget deficit might affect the U.S. and world economies. O'Neill noted that the U.S. economy, which currently accounts for about 25 percent of the world's economy, has become more globalized as the number of its trading partners has increased and as trade barriers, such as tariffs and transport costs, have declined. Despite globalization, the size and relative independence of the U.S. economy allows that domestic economic outcomes will be largely a function of domestic forces. Fiscal and monetary actions, then, can be expected primarily to affect the domestic economy.

O'Neill stated that significant deficit reduction should entail both benefits and costs. A large budget deficit can reduce national saving, crowd out capital investment, and increase U.S. borrowing from foreigners. Slower economic growth results from a smaller capital stock which, in turn, lowers productivity, thereby reducing wages and income. The magnitude of these effects would depend on the magnitude and persistence of the deficit.

However, O'Neill believes, even if legislation were passed and the budget balanced by the year 2002, the aging of the population and the resulting burden of Social Security and health care costs could push the budget out of balance again and eventually push deficits to ever higher levels. The Congressional Budget Resolution for fiscal year 1996 does not address Social Security, and even though it would reduce Medicare spending below levels anticipated under current policy, growth in Medicare spending will continue to exceed growth in the economy. Policymakers' general recognition that current policy is not indefinitely sustainable has lead to general agreement about balancing the budget. Current disagreements are about the composition of the deficit reduction package and issues of timing.

According to O'Neill, in the short run we can expect that a balanced budget by the year 2002 will lead to an economy that would grow modestly faster (about 0.1 of a percentage point per year on average) than if fiscal policy continued on its current path. After accounting for both the increase in the level of the capital stock and a reduction in the debt service paid to foreigners, the CBO estimates that GNP might be about 0.8 of a percent higher in 2002 than if fiscal policy continued on its current path, with something more than half that gain resulting from increased U.S. production and something less than half from reduced foreign debt servicing. Over the longer run, however, the benefits of deficit reduction would be substantially higher as a result of increased capital accumulation and growth. The CBO anticipates that higher national saving induced by deficit reduction would lower U.S. interest rates between 100 and 200 basis points.

O'Neill explained that because the U.S. economy is relatively large, domestic policy changes would likely affect world capital markets and interest rates. Theoretically, a short-term effect of a decline in the U.S. budget deficit would be a fall in the dollar, although equilibrating forces would, in the longer term, result in dollar appreciation. However, the empirical evidence on the relationship between deficit reduction and exchange rates is decidedly mixed.

Dentzer noted during the panel discussion that the administration's forecasts have been closer to actual figures than the CBO's in the last few years. O'Neill pointed out that the administration and the CBO are nearly identical on economic growth assumptions. However, differences in the assumptions about the spread between the GDP deflator and the CPI are significant. O'Neill also stated that over the past 20 years the administration's estimates have usually been more optimistic than the CBO's relative to what actually occurred. Minarik responded that the current administration's record in forecasting is different from that of the administrations of the past 20 years. Over the last three years the economy has outperformed OMB's forecasts. Lindsey commented that the focus of the debate should be on the size of the spending cuts and not on whether the underlying budget forecast produces zero one way or another.

# Conference Program

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| 8:00 a.m. | **Registration** |
| 9:00 a.m. | **Opening Remarks: Dimitri B. Papadimitriou,** Executive Director, The Jerome Levy Economics Institute and Executive Vice President, Bard College<br>**The Honorable Lawrence H. Summers**, Deputy Secretary, U.S. Department of the Treasury |
| 10:00 a.m. | **The Honorable Robert Bennett**, U.S. Senate |
| 10:45 a.m. | **The Honorable Daniel Patrick Moynihan**, U.S. Senate |
| 11:30 a.m. | **Forum:** National Economic Policy for 1996 and Beyond<br>**Judy Woodruff (moderator)**, Prime Anchor, CNN<br>**The Honorable Amo Houghton**, U.S. House of Representatives<br>**Barry Rogstad**, President, American Business Conference<br>**Gene Sperling**, Deputy Assistant to the President for Economic Policy |
| 1:00 p.m. | **Luncheon Speaker: David A. Levy**, Vice Chairman and Director of Forecasting, The Jerome Levy Economics Institute |
| 2:30 p.m. | **Panel Discussion:** U.S. Economic Prosperity Within the Global Perspective<br>**Susan Dentzer (moderator)**, Chief Economics Correspondent, *U.S. News & World Report*<br>**The Honorable C. Christopher Cox**, U.S. House of Representatives<br>**The Honorable Lawrence B. Lindsey,** Member, Board of Governors of the Federal Reserve System<br>**Joseph Minarik**, Associate Director, Office of Economic Policy of the Office of Management and Budget<br>**The Honorable June E. O'Neill,** Director, Congressional Budget Office |

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